on record with compatible views about a premise of collusive markets, and without developing a record to establish such premise. It has also looked to these partisans to come up with measurements intended from the start to be higher than actual lease sale prices. The question whether lease markets are functioning competitively is a complex one that requires assessment of massive amounts of information about transactions in lease and other markets and about complex factors affecting supply, demand, and market price. Given the dynamic nature of oil markets, that examination cannot reasonably be based on evidence that is a decade or more old. MMS attempted no current studies to corroborate its assumed conclusions of market misbehavior. Accordingly, the proposed rule lacks an evidentiary basis and appears to reflect a simple prejudgment of complicated issues. These circumstances irreparably compromise the entire rulemaking.

A. The Proposed Rule Rests on a Premise of Collusive Markets.

The proposed rule states that its purpose and intent is to "eliminate any direct reliance on posted prices" because posted prices do not reflect "market value." 62 Fed. Reg. 3742. The NOPR makes clear that MMS does not seek comments on its premise that posted prices are "suspect." For example, "MMS requests suggestions on ways to value Federal oil production based on market indicators in the vicinity of the lease, with the following in mind: (1) The methods should not rely on posted prices unless they account for the difference between postings and market value." Id. at 3746. The premise of collusive underpricing by major oil companies was established for MMS, without notice, comment, or industry participation, by the Inter-Agency Task Force ("IATF") whose final Report was issued in May of 1996. **30/** The NOPR, however, makes no mention of the IATF Report.

30/ Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California, prepared for the Assistant Secretary - Land and Minerals Management and the Director of the Minerals Management Service, United States Department of the Interior ("IATF Report") (May 16, 1996) (attached in the

MMS has long recognized that it may ignore posted prices, arm's-length transactions, and buy/sells or exchanges only if there is a threshold determination of collusive behavior that would make prices in such transactions "suspect." For example, in 1986 MMS rejected a netback proposal from plaintiffs in litigation alleging collusive underpricing, in part because a netback cannot illuminate the threshold question whether the market is functioning competitively:

> We do not agree that the RPV [netback] cross-check as proposed can, in and of itself, establish that a given posted price is either valid or invalid. Neither do we agree that RPV should be used in establishing royalty value. The real issue here in determining whether postings represent market value is whether a competitive and open market exists. An RPV analysis cannot provide an answer to this question . . . . To apply RPV analysis in lieu of market prices would imply acknowledgment that it is a fairer method for establishing royalty value than the market itself.

Letter from Director, Mineral Management Service, to James Tucker, State of California Controller's Office 1-2 (October 1987) (attached in the Appendix hereto as Exhibit 11).

A presentation by an expert consulted by MMS for the present NOPR also made the point that one may rationally ignore buy/sells and other arm's-length transactions only if the market is collusive, but may not use them to determine collusive underpricing. Dr. Michael Harris of the Reed Consulting Group observed that "[buy/sell] arrangements are arm's length to the extent that the behavior of the market participants is non-collusive. If the market is characterized by collusive behavior, all transactions (e.g. straight purchases) are suspect." Michael Harris, Market Valuation of Domestic Crude Oil for Royalty Purposes 9 (Aug. 22, 1996) (presentation made to Minerals Management Service) (attached in the Appendix

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Appendix hereto as Exhibit 10). DOI formed the IATF in June of 1994, consisting of one member each from the Departments of Energy, Commerce, Justice (Antitrust Division), and Interior. The Justice Department representative resigned in 1995 and did not endorse the IATF Report or provide any recommendations.

hereto as Exhibit 12). Thus, one can only understand the conclusions of the IATF Report and the proposed rule as arising, implicitly or explicitly, on prejudgments of collusion. 31/

The premise that postings and actual prices at the lease are not competitive is so imbedded in the proposed rule that MMS admits that reliance on actual lease transaction prices ("gross proceeds") "would be limited." 62 Fed. Reg. 3742. For almost any lessee/producer with integrated operations in crude oil trading, marketing, or refining, no sales at the lease will qualify as proper measures of lease market value. MMS concludes that "[d]ue to the widespread use of exchange agreements and frequent reciprocal sales among companies — particularly major integrated firms — MMS expects that a relatively small volume of Federal oil production would be valued using the arm's-length gross proceeds method." Id. at 3744. Certainly all of Mobil's lease sale transactions are effectively disqualified by the proposed rule.

The hostility to any kind of "reciprocal" activity is explicitly addressed in direct statements that exchanges and buy/sells, widely used in the industry for most of the century, are "suspect" because they might be used as conspiratorial devices to "hide" the real price or consideration in the transaction. 32/ The reasons

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31/ The IATF Report relies on an adjusted netback from a downstream spot market to justify ignoring actual arm's-length transactions. Ex. 10 at 74-76.

32/ "Because of the frequency of oil exchange agreements, reciprocal deals between crude oil buyers and sellers, and other factors where the real consideration for the transaction could be hidden, arm's-length contract prices would be used as royalty value only by producers who do not also purchase crude oil." 62 Fed. Reg. 3742 (emphasis added).

"[M]ultiple dealings between the same participants, while apparently at arm's-length, may be suspect concerning the contractual price terms. . . . [A] producer may have less incentive to capture full market value in its sales contracts if it knows it will have reciprocal dealings where it may be able to buy oil at less than market value." Id. at 3743 (emphasis added).

for rejecting all such reciprocal transactions make no economic sense unless one assumes that such transactions are the product of collusion. See generally, supra Part II.H.; Ex. 12 at 9. Moreover, "frequency" or "multiple dealings between the same participants" are not rational bases for determining that apparently arm's-length transactions are not actually arm's-length. Thus the MMS premise that posted prices do not reflect market value, and its corollary rejection of posted price terms or other actual prices in expressly reciprocal transactions such as buy/sells, is based on a premise that lease markets are operating collusively, not competitively. This is a startling conclusion of great consequence made all the more remarkable by its presentation in the NOPR without support, explanation, question, or request for comment.

B. MMS' Premise of Collusive Markets Uncritically Adopts The Losing Side of a Long-Standing Debate Over Posted Prices.

Alleged collusive underpricing has been the subject of major prior litigation, as well as other proceedings, all based on very substantial evidentiary records. None have resulted in any findings of lack of competition, of conspiracy, of tacit collusion, or of other problems with posted prices or exchanges and buy/sells. Like the MMS, complaining parties in these matters attacked posted prices directly and attacked exchanges and buy/sells as mechanisms that allegedly assist in fixing posted prices and other lease transactions at prices below alleged "true" market value at the lease. All looked at downstream, integrated activities to attempt to

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"The reason MMS would not accept the contract price for oil subject to an exchange agreement is that the prices stated in an exchange agreement may not reflect actual value." Id. at 3744 (emphasis added).

As with multiple dealings between two parties, MMS would presume that the price of oil sold under arm's-length contracts subject to crude oil calls is suspect. This is because the sale terms **may** be liberal to the property buyer in return for a favorable product purchase price by the property seller." Id. (emphasis added).

explain or bolster their conclusions and all collapsed when evidence failed to corroborate the theories.

- FTC Divestiture Litigation: In 1973 the Federal Trade Commission filed an Administrative Complaint to break up the eight largest U.S. oil companies based on a "shared monopoly" theory that vertical integration resulted in noncompetitive market outcomes. **33/** The acts and practices complained of included an alleged "system of posted prices leading to the maintenance of an artificial level for the price of crude oil." Complaint ¶ 16(c). After developing a massive evidentiary record, the FTC withdrew its complaint in 1981 as "not in the public interest." **34/** By that time, the "shared monopoly" theory had been discredited **35/** and the procompetitive efficiencies of vertical integration widely recognized by the federal government and economists generally. **36/**

33/ Exxon Corp., Dkt. No. 8934, issued July 18, 1973, reprinted in 98 F.T.C. 453 (1981). The Complaint did not address areas west of the Rockies.

34/ Order of the Federal Trade Commission, Sept. 16, 1981, reprinted in 98 F.T.C. 453. As a face-saving matter, the dismissal was without prejudice in order to permit "more focused" proceedings. Id. at 461. No further prosecutions ensued.

35/ Leading economic and antitrust thinkers who had once advocated government action based on theories of oligopoly or shared monopoly recanted. E.g., William Baxter, How Government Cases Get Started -- Comments from Academe, 46 Antitrust L.J. 586, 588 (1977) ("As one of the original drafters of the deconcentration act, . . . it seems particularly appropriate to me that I recant."); George Stigler, Testimony Before the House Special Subcomm. on Small Business, 1969, quoted in Brozen, The Concentration-Collusion Doctrine, in Industrial Concentration and the Market System 90, 92 n.8 (1979)). A summary of reversals of opinion among important economic and antitrust spokesmen is contained in Brozen, supra. See also, e.g., Weston, "Implication of Recent Research for the Structural Approach to Oligopoly" in The Competitive Economy 86, 93 (Y. Brozen ed. 1975); Harold Demsetz, "Two Systems of Belief About Monopoly" in Industrial Concentration: The New Learning 164 (1974).

36/ F.M. Scherer, Industrial Market Structure and Economic Performance 70 (1970) (Former Director of FTC's Bureau of Economics); Robert H. Bork, The Antitrust Paradox 225-45 (1978). For a general discussion of the efficiencies of vertical integration, see Oliver Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975); David Teece, Vertical Integration and Vertical Divestiture in the U.S. Oil Industry (1976) (doctoral dissertation). Robert H. Bork,

- Other Divestiture Initiatives. Attacks on vertical integration received initially friendly hearings in Congress, which also considered legislation mandating vertical divestiture at several levels of operation 37/ or just of crude oil pipelines 38/ in order to remedy perceived advantages available to companies who had invested in such operations. After due consideration on substantial records, no federal divestiture initiatives were enacted.

The MMS proposed rule revives these outdated suspicions of both large firms and integrated operations, and ignores the recognized efficiencies such operations create in an industry typified by high risk, high capital costs, finite resources, and the need for continuous flow operations. Thus MMS condemns integrated companies, without proof, for presumptive misconduct and/or lack of competition by promulgating rules that systematically penalize normal integrated-company activity. See supra Part II.F. (discussing proposed rule's discriminatory treatment of vertically integrated firms).

- Long Beach I litigation: In 1975 the City of Long Beach and the State of California, acting in their proprietary capacities, filed suit against eight firms eventually seeking approximately a billion dollars in damages for alleged crude oil underpayments. The City and State alleged that the posted prices for California crudes were artificially depressed as a result of a conspiracy in violation of the antitrust laws and in breach of a working interest contract. 39/ They attacked "three-cut" crude oil exchanges and buy/sells as allegedly revealing hidden prices proving that the true value of crude oil was higher than transaction prices/postings in the field.

Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception, 22 U. Chi. L. Rev. 157, 194-201 (1954).

37/ Hearings on S. 2387 and Related Bills (Part 1) Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 94th Cong., 1st Sess. (1975).

38/ Hearings on S. 2387 and Related Bills (Part 3) Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 94th Cong., 2d Sess. (1976).

39/ City of Long Beach, et al. v. Standard Oil Co. of Cal., et al., No. CV-75-2232 (WPG) (original complaint filed June 27, 1975).

They also attempted to calculate crude prices on the basis of refined product values. Their exchange and refining value theories were an unabashed effort to expropriate downstream added values, in that case value in the refinery reflecting the prices of products that can be refined from particular crude oils, and to attribute that value to crude in the field for royalty and related purposes. 40/ The litigation ended in settlements with seven defendants by 1991. Plaintiffs tried their claims against remaining defendant Exxon and lost before a jury in 1992; that judgment became final in 1995. 41/

- Long Beach II litigation: In 1986 the City of Long Beach and the State of California brought another lawsuit raising the same claims as Long Beach I for a later time period and seeking far greater damages. 42/ Settlements of most claims occurred by 1991, combined with settlements of Long Beach I.

- California Pipeline Case: Certain claims in Long Beach II regarding heated crude oil pipelines owned by Chevron, Mobil, and Texaco could not be settled and were tried in 1993. The City of Long Beach and the State of California believed that private integrated operation of these heavy crude pipelines carrying crude production from the San Joaquin Valley had anticompetitive effects depressing crude oil prices, and they sought remedies to force opening the lines to the public for hire under California law. Plaintiffs' theories of violation also rested on alleged problems with crude oil exchanges. In ruling for the three defendants on appeal, the court found that acquisitions of crude, whether outright or by exchange, were "purchases" that were "legitimate, arm's-length transactions supported by consideration and memorialized in

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40/ See Ex. 5 (describing and rejecting RPV netback methodology favored by State of California); compare Ex. 3 (considering and rejecting netback valuation methods based on spot and futures market prices).

41/ City of Long Beach v. Standard Oil of Cal., 46 F.3d 929 (9th Cir. 1995).

42/ People of the State of California, et al. v. Chevron Corp., et al., No. C587912 (Cal. Sup. Ct.) (filed Feb. 19, 1986). The Long Beach II complaint was filed in state court and set forth the theories of underpricing and exchange misconduct under state rather than federal antitrust law, while adding specific state law claims relating to pipeline operations.

separate written contracts." 43/ Plaintiffs also tried unsuccessfully to demonstrate that defendants violated the common carrier provision of the Mineral Leasing Act. 44/

- Current Royalty Litigation. Commencing in 1995, varying groups of private and state governmental royalty owners brought new lawsuits that recycle the theories pressed in the above matters with some variations. Some focus on alleged breaches of royalty contracts and related oil and gas law provisions, and some allege undervaluation of crude oil in making state severance tax payments. All rest on net back theories viewed by at least one court as "novel" in the sense that they lack "precedent." 45/ At least two lawsuits, known as McMahon and Lovelace, directly raise issues of competition by alleging conspiracies to depress posted and/or wellhead prices in violation of state or federal antitrust laws for the period 1986 forward. 46/

Like the MMS proposed rule and certain pending MMS audit matters, and like the Long Beach litigation, the Royalty Litigation cases attempt to discredit actual lease transactions, particularly including exchanges and buy/sells, in order to attempt to prove alleged higher lease market value derived from prices or value in downstream markets. As with the MMS proposed rule, the key to higher valuation in those cases is to espouse principles guaranteed to capture some or all of the value added through downstream marketing by or for the leaseholder.

Complainants in all the above proceedings have perennially lobbied federal agencies to adopt and press their theories through government action; after due consideration, the government rebuffed the claims. 47/ MMS in particular met

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43/ People v. Chevron Corp., slip op. at 5, 11, No. B078250 (Cal. Ct. App. 2d Dist. 1994) (attached in the Appendix hereto as Exhibit 13).

44/ Id. at 13; Ex. 7 at 15-17.

45/ Ex. 2 ¶ 10, at 2.

46/ The McMahon Foundation, et al. v. Amerada Hess Corp., et al., No. H-96-1155 (S.D. Tex.) (filed Apr. 10, 1996); E.M. Lovelace, Jr., et al. v. Amerada Hess Corp., et al., No. CV-96-297 (Cir. Ct. Escambia County, Ala.) (filed Sept. 12, 1996).

47/ For example, at Congress' request in light of the Long Beach allegations, the General Accounting Office investigated whether posted prices in California were frequently with representatives of the Long Beach plaintiffs from at least 1986. 48/. Until about 1995, MMS investigation of the substantial evidence from the Long Beach litigation and other matters consistently resulted in determinations that: (1) posted prices remained valid indicators of lease market prices; (2) substantial arm's-length transactions occurred at posted prices; and (3) actual lease market transactions were the best evidence of lease market value. 49/ In particular, MMS

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indicators of fair market value, concluding that MMS should continue to base royalties on postings. General Accounting Office, California Crude Oil: An Analysis of Posted Prices and Fair Market Value 22 (Sept. 1988) (attached to the Appendix hereto as Exhibit 14). The Internal Revenue Service commissioned a study by Arthur D. Little, Inc. that concluded that "California posted prices are a proper basis for calculation of taxes and royalties" because substantial quantities of crude were traded between unaffiliated companies at such prices. Arthur D. Little, Inc., Evaluation of California Crude Oil Prices for 1980-1983, Report to IRS (Sept. 1987) (attached in the Appendix hereto as Exhibit 15); Ex. 16, Att. 1 at 1, (stating that Royalty Management Program found "[n]o convincing evidence that postings [in California] were below market value during the period [1986-92]"). Again in 1991, Long Beach plaintiffs persuaded the Department of Justice Antitrust Division to investigate its allegations about posted prices, and again the government concluded no action was warranted. See id. Att. 1 at 9.

48/ Memorandum from Chief, Royalty Valuation and Standards Division, to Associate Director for Royalty Management (Aug. 8, 1996) (attached in the Appendix hereto as Exhibit 17); Memorandum from Economist, Economic Valuation Branch, and Physical Scientist, Economic Valuation Branch, to Royalty Valuation and Standards Division Files 2-3 (Aug. 12, 1986) (attached in the Appendix hereto as Exhibit 18); Memorandum from Associate Director for Royalty Management to Director for Royalty Management 2-3 (Feb. 10, 1994) (attached hereto as Exhibit 19). These documents refer to many meetings with the lawyers representing the Long Beach plaintiffs as well as their consulting firms and show that MMS expended substantial effort with access to large portions of the Long Beach records and to the work of plaintiffs' economic consultants. As recently as 1993, MMS reviewed substantial "evidence that was entered as testimony during the [Long Beach] trials," Ex. 16, Att. 2, at 1, but again rejected the allegations. Id. Att. 1, at 1. The IATF report also summarizes such contacts Ex. 10 at 1, 14, 17, 24-26, but, in justifying the about-face taken by MMS in that report and currently, contradicts the more contemporaneous reviews by suggesting that MMS chose not to extensively review Long Beach evidence and materials. Id. at 14-15.

49/ "MMS sees no reason to alter its historical operating policy of accepting the arm's-length posted price received by the lessee as value for royalty purposes for oil did not accept the conclusions pressed by plaintiffs in Long Beach that collusion or misconduct made the market non-competitive and so would justify ignoring lease market transaction prices or postings. **50**/ MMS apparently now reaches such conclusions even though there is little or no evidence of MMS efforts to balance the Long Beach plaintiffs' presentations with comparable presentations from parties on the other side of the California pricing debate.

C. MMS Adopted The Premise of Collusive Markets Without a Sufficient or Balanced Record.

In 1995, MMS appears to have changed course and began adopting the conclusion that crude oil markets are not competitive. No new evidence is cited in the documents available to Mobil that would explain this about-face. The most Mobil can discern is that MMS reconsidered now out-of-date Long Beach plaintiff information in light of the settlement of the Long Beach cases, extrapolated it forward in time and to other areas of the U.S., and bolstered it by consulting further with Long Beach plaintiff consultants and by reference to unproved allegations in the current Royalty Litigation. See, e.g., Ex. 10 at 1, 3, 13-15. **51**/ The Long Beach

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from onshore Federal leases in California." Ex. 5 at 4. "We continue to believe that the best available indicators of market value are the oil contract and posted prices actually paid for the first product, crude oil. . . . We have no reason to believe that the results of [a refinery netback] analysis would be more valid. Most importantly, we have no evidence of undervaluation of California crude oil that would render contract and posted prices invalid." Ex. 11 at 2. "Through the years [from the 1970's] MMS and the State of California conducted routine audits . . . The auditors generally relied on posted prices as valid measures of market value because significant quantities were traded and sold at posted prices." Minerals Management Service Valuation & Standards Division, Overview of the California Oil Market 1 (June 1995) (attached in the Appendix hereto as Exhibit 20).

50/ Ex. 5 at 3-4 (notwithstanding the allegations made by State of California representatives, MMS refused "to alter its historical operating policy of accepting the arm's-length posted price received by the lessee as value for royalty purposes for oil from onshore Federal leases in California).

51/ A 1994 study of the California oil market for the period 1986-1994 summarizes MMS prior investigations and its consistent conclusions, through 1992, records have not changed from the time when MMS found them insufficient and cannot, in any event, support findings that prices in the lease markets are currently the product of misconduct. 52/ Litigation settlements cannot properly be considered as evidence of any misconduct. 53/

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that rejected the Long Beach allegations and purported proof and found "no convincing evidence that postings were below market value . . ." and "no convincing information for MMS to establish the California market as noncompetitive." Ex. 16, Att. 1. There is substantial other documentation of these periodic MMS investigations. Minerals Management Service Royalty Management Program, Summary of the California Crude Oil Pricing Issue (Oct. 20, 1994) (attached in the Appendix hereto as Exhibit 21). The 1994 study, Ex. 16, describes how the allegations of underpayment "resurfaced after . . . settlements out of court" in 1991 prompted another study. Id., Att. 1. To support this new study, MMS revisited sell-off data, spot price data, and Long Beach I evidence and filings provided by plaintiffs. The "most substantial evidence" was a 1982 study by Long Beach I plaintiffs' consultants from NERA covering the period 1961-77. Id., Att. 1 at 3. After again reviewing this entire body of evidence, the Royalty Management Program once again reached the same conclusion: "[T]he evidence is insufficient to conclude that oil postings, at least over the period 1986 forward, don't reflect market value. We found no convincing evidence that the integrated majors, or the California oil market in general, act noncompetitively." Id., Att. 1 at 9.

52/ The IATF report states that its efforts were inspired by the 1991 settlement of the Long Beach cases and that it now adopts conclusions from Long Beach documents "that major oil companies often bought and sold crude oil at premiums over posted prices." Ex. 10 at 1, 3, 14-15. These conclusions were extrapolated to the present and supported by the retention of two consultants, also from the Long Beach plaintiffs' team, and by allegations in the current Royalty Litigation. Id. at 13 (relying on Summit Report). The IATF report is quite clear that no defendants in the Long Beach litigation and no others likely to balance the IATF record were consulted. On this patently imbalanced and insufficient record, the IATF adopted the significant conclusion that exchanges and buy/sells were not arm's-length transactions, and that posted prices were depressed and so could be ignored even when used in admittedly arm's-length transactions. Moreover, the IATF Report relies on an adjusted netback from a downstream spot market to justify ignoring actual arms-length transactions. As shown from Ex. 10, this also implies a finding by IATF of collusive markets as the underpinning for its recommended audits and revisions of the current rules.

53/ Such evidence is made expressly inadmissible by Federal Rules of Evidence. Fed. R. Evid. 408; see also Fed. R. Evid. 408 advisory committee's note. ("This Rule

Notwithstanding the absence of a record to support determinations of current collusion or noncompetitive conduct by price posters, MMS proceeds from this point to seek creative ways under existing regulations to calculate "damages," i.e., to substitute values derived from other markets (marginal bids by independent refiners, netbacks from downstream points and the like) via audits and orders-to-pay. 54/ Recognizing that existing regulations impede those efforts, MMS now proposes to rewrite the regulations to implement these creative approaches for the future. Rulemaking based on speculation, rather than demonstrable economic effect, and excluding thousands of arm's-length transactions purely on the basis of fear of noncompetitive pricing lacks rational footing and is therefore arbitrary, capricious, unfair, and unreasonable.

MMS faces a great burden of justification when it purports to exercise authority not previously recognized. Courts look more strictly at agency

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as reported makes evidence of settlement or attempted settlement of a disputed claim inadmissible when offered as an admission of liability or the amount of liability."). An offer of settlement "does not ordinarily proceed from and imply a specific belief that the adversary's claim is well founded, but rather a belief that the further prosecution of that claim, whether well founded or not, would in any event cause such annoyance as is preferably avoided by the payment of the sum offered. In short, the offer implies merely a desire for peace, not a concession of wrong done." 4 J. Wigmore, Evidence § 1061, at 36 (Chadbourn rev. 1972); see, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975) (noting in the securities context that "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment" and citing interruptions in defendants' normal business activities, and the potential for abusive discovery). Mobil and class counsel for plaintiffs in the Lovelace action recently entered into a stipulation and proposed agreement of settlement that is not yet final. Mobil made this agreement in order to end the private party actions and to secure "peace;" the agreement is not and should not be construed as an admission of any wrongdoing by Mobil or endorsement of plaintiffs' pricing theories.

54/ E.g., Ex. 21 at 1 (noting that MMS used "unverified data from plaintiffs' legal counsel and their consultants" to estimate "a theoretical maximum underpayment of about $400 million for 1960-1992").

rulemaking when there has been, as here, "a significant departure from long-standing policy." Humana of Aurora, Inc. v. Heckler, 753 F.2d 1579, 1582 (10th Cir.), cert. denied, 474 U.S. 863 (1985). When such a departure occurs, there is a "substantive need" for the agency to articulate fully and clearly the basis of the change. Id.

> If the [NOPR] fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals . . . In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules.

Connecticut Light and Power Co., 673 F.2d at 530; Florida Power & Light Co. v. United States, 846 F.2d 765, 771 (D.C. Cir. 1988) ("notice must not only give adequate time for comments, but also must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully"), cert. denied, 490 U.S. 1045 (1989). The absence of a sufficient record to support the current rulemaking proposal should prove fatal.

Aside from issues of sufficiency of the record, the rulemaking will be defective because it proceeds from a biased record. Consideration of issues has been overly influenced by heavy reliance of proponents of underpricing theories from failed prior litigation such as the Long Beach cases. When the IATF and MMS determined to revisit royalty valuation issues during the past two years, they retained consultants already known to be committed to collusive market theories and already on record as prepared to demonstrate alleged "underpricing." The IATF, for example, retained the same experts who had previously collaborated with counsel for Long Beach plaintiffs in order to lobby MMS to accept underpricing theories and purported "evidence" from the Long Beach litigation. **55/** MMS relied

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55/ IATF retained Mr. Peter Ashton, one the Long Beach plaintiffs' retained consultants and a witness for plaintiffs' unsuccessful trials of Long Beach I, and the reserved Long Beach pipeline trials. Mr. Ashton is currently retained by certain on these same two consultants plus a third equally committed to MMS' new premise. 56/ It is not possible that MMS or the IATF expected an objective or fresh look at the issues from this group; certainly none could have been expected to present views different from those each had previously and publicly asserted. No meaningful effort to engage consultants likely to air competing views or to otherwise develop a balanced record was undertaken.

Similarly, the construction of MMS' Advanced Notice of Proposed Rulemaking ("ANOPR"), on which the agency also relies to support the current proposal, elicited only one side of the debate. See supra Part IV.B. Those whose participation was uninhibited by pending litigation, thus predictably dominated the substantive ANOPR responses and preserved a uniquely one-sided record. 57/

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plaintiffs in at least one of the Royalty Litigation cases. IATF also retained Jeffrey Leitzinger, another consultant with a long history supporting plaintiffs in the various Long Beach cases, who is also retained in current Royalty Litigation matters.

56/ At a recent Congressional briefing, MMS reported that, in order to develop the proposed rule, it "met with several crude oil consultants including" Micronomics (Mr. Leitzinger), Innovation & Information Consultants (Mr. Ashton), and Summit Resources (Benjamin Johnson, CEO). Summit Resources was previously committed to the plaintiffs in the current Royalty Litigation. It is a crude oil marketing organization whose stated business objective is "adding value for independent petroleum producers and royalty owners." See Professional Resume of J. Benjamin Johnson, Jr., (updated Aug. 12, 1995) (attached hereto as Exhibit 22).

57/ It does not appear that MMS looked behind some assertions made in comments to the ANOPR. For example, the City of Long Beach and the State of California, in their comments, contend that "[u]nder California law, as interpreted by the Majors, privately owned pipelines have no duty to transport crude for others." Comments of City of Long Beach to ANOPR (Mar. 19, 1996) (hereinafter referred to as "Long Beach Comments") (emphasis added). At no time do the City or the State of California mention that they attempted to compel those three pipelines to operate as common carriers under California state law and were rebuffed by the California courts. See Ex. 13 (holding that three heated pipelines discussed in Long Beach's comments in San Joaquin Valley had not been dedicated to public use and therefore were not common carriers or public utilities under California law).

None of this is evident in the proposal itself, or any of the press releases and other agency comment on the proposal. Rather, such agency descriptions decline to name the participants on whom MMS relied, suggesting that a balanced, industry-wide record preceded the proposal.

> MMS used various sources of information to develop the proposed rule. In addition to comments received on the Advance Notice of Proposed Rulemaking, MMS attended a number of presentations by: crude oil brokers and refiners, commercial oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. MMS' deliberations were aided greatly by a wide range of expert advice.

62 Fed. Reg. 3742. Moreover, no studies by these unnamed consultants are identified. Only through subsequent FOIA requests has Mobil obtained access to cryptic visual-aids used in presentations by the consultants and experts, or their outdated audit reports for specific companies. No actual studies or record evidence have been revealed and certainly nothing to support the statement that MMS' consultants were "knowledgeable in crude marketing" or represented a "wide range"

Further, it appears that MMS gave considerable weight to Long Beach's unsupported claims that the proprietary status of pipelines in the San Joaquin Valley gave producers only three options: (1) to leave their crude oil in the ground; (2) to transport their crude by truck; or (3) to sell their crude to a pipeline owner. See Long Beach Comments at 3-4. But according to uncontroverted evidence presented at the trial of the pipeline issues, the total pipeline capacity capable of transporting crude out of the San Joaquin Valley is some 960,000 barrels per day, while only 702,000 barrels of crude were produced in that region daily. Testimony of Richard J. Gilbert, Ph.D., in People of the State of California, et al. v. Chevron Corp., et al., No. C587912, Feb. 11, 1993, at 2546-61 (attached in the Appendix hereto as Exhibit 23). When crude consumed in the Valley — some 220,000 barrels per day — is deducted, there is a net total of approximately 482,000 barrels per day available to be transported out of the Valley, roughly one-half of the available pipeline capacity. 300,000 barrels of that available capacity is on the common-carrier All-American pipeline. Id. Subsequent to his testimony in that case, Dr. Gilbert served as the chief economist in the Antitrust Division of the United States Department of Justice.

of relevant expertise. Id. It is axiomatic that reliance on unidentified studies is improper. Humana of Aurora, 753 F.2d at 1582 (reliance on "unidentified consultant's study" resulted in absence of "fundamental nexus between evidence and agency action").

Thus, the proposed rule was crafted on the basis of one-sided evidence, and uncritically embraces one side of a complex debate. MMS cannot rely on its own ipse dixit about lack of competition or speculate about the possibility of misconduct as a basis for revamping its valuation rules. Agency rulemaking on such a record is "arbitrary and capricious." See Gas Appliance Mfrs. Ass'n v. Department of Energy, 998 F.2d 1041, 1046 (D.C. Cir. 1993) (computer model does not consider all factors); Natural Resources Defense Council v. Herrington, 768 F.2d 1355, 1420-21 (D.C. Cir. 1985) (assumption in model overstated indebtedness); St. James Hosp. v. Heckler, 760 F.2d 1460, 1467 (7th Cir.) (study undergirding Medicare regulation had biased data base; hence, regulation invalidated), cert. denied, 474 U.S. 902 (1985); Humana of Aurora, 753 F.2d at 1583 (biased report formed basis of Medicare regulations). Moreover, courts are critical when an agency promulgates a rule without investigating important aspects of the issue. See St. James Hospital, 760 F.2d at 1468 ("Compounding the statistical limitations of the study itself, moreover, the Secretary promulgated the Rule without investigating several other important aspects of the malpractice problem. . . .").

V. MMS IS IGNORING WELL-DEFINED STATUTORY AND HISTORICAL LIMITS ON ITS AUTHORITY.

A. MMS Is Limited to Capturing Royalty Valuation on "Production" at the Lease.

A fundamental problem with the proposed rule is the intent and effect to capture a royalty on the value added to crude oil by downstream marketing investments. This is a departure from historical practice that takes MMS beyond the limits of its legal and contractual authority.

Federal ownership of mineral rights involves no more than physical property rights in situ. From its passage in 1920, the Mineral Leasing Act has confined royalty assessments to a percentage share of the "amount of production" and, by amendment in 1946, to a share of the "amount or value of the production removed or sold from the lease." 30 U.S.C. § 226. Like the private arrangements common in 1920 for private lessors, which provided the model for the original MLA, 58/ "production" under federal law means "the actual physical severance of minerals from the formation." Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1168 (5th Cir. 1988) (referring to the "legal definition of the word 'production' ").

A leasing system permits the government as landowner to obtain value for a property right whose potential yield is unknown where government lacks the necessary equipment, finance, or skill to develop and produce the property or otherwise chooses not to do so. 59/ By contracting with another party to produce

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58/ See Williams, Understanding the Strange New World of Federal Oil and Gas Royalty Valuation, 33 Rocky Mt. Min. L. Inst. § 19.03, at 19-17 (1987); Dante L. Zarlengo, Law of Federal Oil & Gas Leases § 13.01[1] (1995) ("The influence of privately negotiated transactions on royalty concepts adopted by Congress cannot be overstated."); Ross L. Malone, Jr., Oil and Gas Leases on United States Government Lands, 2 Oil & Gas Inst. 309, 315 (S.W. Legal Found. 1951) (noting that the United States Geological Survey conducted a nation-wide survey to determine average private landowner royalty rates in preparation of the initial MLA); accord H.R. Rep. No. 2078, 81st Cong., 2nd Sess. 9-10 (1950); H. R. Rep. No. 695, 82nd Cong., 1st Sess. 12 (1951) ("[T]he Committee [considering enactment of the OCSLA] believes it desirable to give consideration to the terms of leases which have been developed and are in general use in the industry after a long period of trial and error and to the terms of leases granted by the coastal States under which operations in the Continental Shelf have been conducted.").

59/ This justification was articulated at the time Congress passed the MLA. See Cong. Rec. S4270 (Aug. 25, 1919) (There "are altogether 40,000,000 acres of land out West that may contain oil. Nobody knows. The Government of the United States is not going to take any chances upon drilling over this 40,000,000 acres for the purpose of discovering oil. The Government of the United States cannot afford to go into the oil-prospecting business.") (Senator Walsh (Mont.)); see also Diamond Shamrock, 853 F.2d at 1167 (government leases in order to avoid market risks in exploration, production, and sales of leased minerals).

any crude oil in return for a share of unknown future production, both parties best allocate the risks facing each side of the lease transaction. Outright sale of mineral rights is usually too risky for each — the lessor risks pricing the assets too low, the lessee too high. A mineral lease based on a percentage royalty system reduces the risks to both sides that are associated with the uncertainties of unexploited mineral rights. 60/ The lessor, however, cannot offer for sharing purposes more than it starts with: the mineral rights in situ. Thus a royalty remains commonly defined as the lessor's share of production free of production costs. See, e.g., Heritage Resources, 939 S.W.2d 118 (Tex. 1996). The Mineral Leasing Act recognizes and codifies this fundamental relationship between lessor and lessee. E.g., United States v. General Petroleum Corp., 73 F. Supp. 225, 234 (S.D. Cal. 1946) (value in the MLA means "reasonable market value" at the well), aff'd sub nom. Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Marathon Oil Co. v. United States., 604 F. Supp. 1375, 1386 (D. Alaska 1985) (royalties allocate the value of the production, or the production itself, at the lease), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987).

The point of royalty determination is not materially different under the Outer Continental Shelf Lands Act ("OCSLA"), 43 U.S.C. § 1301 et seq.; id. § 1331 et seq.; id. § 1801 et seq. Under OCSLA, royalty assessments are limited to a percentage of the "amount or value of the production saved, removed, or sold." Id.

60/ As one author observed in a discussion of the historical development of the petroleum royalty lease:

> Since the owners of the land had seldom the money or the faith to test the productivity of their holdings, it was inevitable that they should grant to others the privilege of exploration and production in consideration of a portion of the product obtained. . . . [The landowner] had neither the money nor the faith in the venture, and the lessee did not desire to be burdened with buying land for the risk of undiscovered wealth. Thus the lease filled a peculiar need . . .

Moses, The Evolution and Development of the Oil and Gas Lease, 2 Oil & Gas Inst. 1, 10-11 (S.W. Legal Found. 1951).

§ 1337(a)(1) (emphasis added). This language has been construed in the same manner as the near-identical language in the MLA. See, e.g., Amoco Prod. Co. v. Andrus, 527 F. Supp. 790, 794 (E. D. La. 1981) ("[I]n structuring the royalty provision of [OCSLA], the Congress borrowed the phrase 'removed or sold' from the [MLA] . . . Congress was aware of, and is presumed to have intended that the language be defined consistently with, the long-standing Interior Department interpretation of the 'removed or sold' language used in the royalty provision of the [MLA]."); Diamond Shamrock, 853 F.2d at 1168 (adopting as the "legal definition of the word 'production,' as used in the context of calculating royalty payments [under OCSLA], the actual physical severance of minerals from the formation") (emphasis added); see also Independent Petroleum Ass'n of Am. v. Babbitt, 92 F.3d 1248, 1258 (D.C. Cir. 1996) (adopting the Diamond Shamrock analysis and distinguishing contrary cases on the ground that they were decided under state law).

Other statutory authorizations cited in the NOPR neither alter nor expand federal leaseholder authority with respect to the method (sharing of "production" by royalty allocation) or point of royalty determination. **61/** MMS is

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61/ The Federal Oil and Gas Royalty Management Act ("FOGRMA"), 30 U.S.C. § 1701 et seq., for example, gives MMS the authority and the responsibility to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system . . . to accurately determine oil and gas royalties" in a timely manner. Id. § 1711 (emphasis added). It does not address the issue of royalty valuation. Similarly, the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 ("FOGRSA"), Pub. L. No. 104-185, § 205, 110 Stat. 1702 (1996) (amending 30 U.S.C. § 1735), focuses on those aspects of the Secretary's authority relating to the establishment of an accounting and reporting system to supervise the collection of royalties, by permitting delegation of certain functions and requiring and authorizing regulations regarding auditing. The Mineral Leasing Act for Acquired Lands, 30 U.S.C. § 351 et seq., with a few unimportant exceptions, simply extends the MLA to certain lands acquired by the Government. Id. § 352 (with a few exceptions, all deposits of oil and oil shale owned or acquired by the United States "may be leased by the Secretary under the same conditions as contained in the leasing provisions of the mineral leasing laws"). Finally, the Indian Mineral Leasing Act, 25 U.S.C. § 396 et seq.; id. § 396a et. seq., and the Indian Mineral Development Act, id. § 2101 et seq., permit Indian tribes to enter into contracts to lease their land for mining purposes as long as the contracts are approved by the Secretary of the Interior. These leases should not be, and without statutory authority to require payment of royalty on prices or proceeds from downstream market centers.

B. The MMS Cannot Create New Implied Duties in Order to Shift the Point of Royalty Determination Downstream.

A principal rationale for the downstream reach of the proposed rule is the assertion by MMS of a lessee duty to "market the oil for the mutual benefit of the lessee and the lessor at no cost to the Federal Government." 62 Fed. Reg. 3753. No such obligation exists, nor is it consistent with the limits imposed by statutes or leases to impose such a duty. The MMS appears to create this new obligation by a semantic trick, in which it compresses the descriptions of two earlier-asserted duties: (1) the duty to place crude oil in marketable condition at no cost to the lessor; and (2) the duty to market crude oil production for the mutual benefit of the lessee and the lessor at the lease. Id. Only the first duty properly arises in the federal lease arena. The second does not, and certainly cannot be enlarged to require lessees to market crude oil for the government downstream for free.

Duties are implied into a contract only when needed to effectuate its purposes. **62/** Federal statutes and lease provisions expressly protect against

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historically have not been, treated any differently than federal leases governed by the MLA.

62/ See Freeport Sulphur Co. v. American Sulphur Royalty Co., 6 S.W.2d 1039, 1042 (Tex. 1928) ("An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument."); see also Continental Potash, Inc. v. Freeport-McMoran, Inc., 115 N.M. 690, 704, 858 P.2d 66, 80 (1993) ("It is not enough to say that an implied covenant is necessary to make the contract fair . . ., or that, without such a covenant, it would be improvident or unwise or [that the contract] would operate unjustly. It must arise from the presumed intention of the parties as gathered from the instrument as a whole.") (quoting Kingsley v. Western Natural Gas Co., 393 S.W. 345, 351 (Tex. Ct. App. 1965) (quoting Danciger Oil &

ineffective lessee efforts to sell from the lease by giving the government the right to take crude oil in kind. 63/ With the express right to take in kind, there is no need to impose marketing duties of any sort. "If the lessor's share of the oil, under the royalty provisions of the lease, is deliverable in kind to the lessor, the oil is theoretically under the control of the lessor and arguably he should be the one to market it, not the lessee." Williams & Meyers, Oil & Gas Law § 853, at 393-94.

Any marketing-like duties associated with federal crude oil leases are properly limited to defining the duties of the lessee producer to meet his express obligation to create "production" at the lease. A duty to place crude oil production in marketable condition arguably is necessary to effectuate the lessor's rights to take crude oil in cash or in kind at the lease. Thus, it has been asserted by DOI and MMS in regulations that declare a duty to put the Government's royalty crude oil "in marketable condition at no cost to the Federal Government." 30 C.F.R. § 206.102(i); see also California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961) (upholding the marketable condition rule). "Marketable condition" is defined for crude oil as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.101. If the proposed rule seeks to expand such understandings of "production" and "marketable condition" as to crude oil, it would exceed the limits of governing statutes and typical lease terms.

DOI and MMS have previously asserted an obligation to "market the production for the mutual benefit of the lessee and the lessor" at the lease. 30 C.F.R. § 206.102(b)(1)(iii), although this duty is not expressed in typical federal leases. This duty is irrelevant, however, where leases expressly permit the Government to take its oil in kind. In any event, DOI has not previously defined

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Refining Co. v. Powell, 137 Tex. 484, 154 S.W. 2d 632 (1941)), cert. denied 510 U.S. 1116 (1994).

63/ See, e.g., 30 U.S.C. § 226 (MLA); 43 U.S.C. § 1337 (OCSLA).

such an obligation as one to be undertaken at no cost to the lessor. **64/** Such obligation, by its terms, also does not support any shift in the point of royalty determination beyond the lease or any change in the definition of "production." When applicable, the duty to market "production" for the mutual benefit of the lessor and lessee has been viewed as a duty upon the lessee to use due diligence to seek a market at the lease, and not as a duty relating to the amount of royalty to be paid. Moreover, costs associated with this limited notion of marketing should be shared by both parties. **65/** Any duty to market production at the lease changes neither the basic royalty relationship nor the point of royalty determination. Royalties must still "be based on the value of the production at the lease." Marathon Oil Co., 604 F. Supp. at 1386.

64/ MMS based an analogous proposal in the natural gas area on similarly alleged duties to market free of cost to the lessor. See Proposed Rules: Amendments to Transportation Allowance Regulations from Federal and Indian Leases to Specify Allowable Costs and Related Amendments to Gas Valuation Regulations (July 31, 1996), 61 Fed. Reg. 39931. Mobil, through the American Petroleum Institute ("API"), contested the existence of such a duty, and that proposal has not been adopted. The decision of the Interior Board of Land Appeals in Walter Oil and Gas Corp., 111 I.B.L.A. 265 (1989), cannot support the newly asserted obligation. DOI cannot create lease obligations by adjudication any more than it can "imply" them by administrative fiat.

65/ See generally Michael P. Irvin, The Implied Covenant to Market in the Deregulated Natural Gas Industry § 18.06[7] (1996) (analyzing analogous implied covenants to market applicable to private leases). Another commentator states:

> The duty of the lessee to deliver royalty gas to the market or to market the gas in the sense of making a sale does not dispose of the question of which party should bear the cost incident thereto.

5 E. Kuntz, A Treatise on the Law of Oil and Gas, § 60.1, at 134 (1991). Professor Kuntz states that the determination of who should bear a particular cost is governed by whether the cost is properly identified as a production cost or whether it is properly identified as a marketing cost, since the lessee traditionally bears production costs but shares marketing costs proportionately with the lessor. Id.

C. MMS Does Not Have the Statutory Authority to Unilaterally Establish the Price of Crude Oil Produced from Government Lands.

Under the proposed regulation, MMS both selects a theoretical index price, and, through publication of permissible levels of adjustments, actually establishes the amount of deductions from that index price permitted to each lessee. This is tantamount to price regulation. In circumstances where Congress intended to bestow upon a federal agency the right to fix prices it has done so explicitly. See, e.g., 49 U.S.C. §§ 1373(a), 1482(d) (1970) (giving the Civil Aeronautics Board the authority to set the price of air transportation fares), repealed by Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705. Noticeably absent from all of the MMS' governing statutes is any language that purports to give MMS or DOI such a power. In fact, the legislative history of the MLA demonstrates that Congress deliberately intended to withhold this power. An amendment to the MLA, offered by Senator La Follete of Wisconsin, that would have granted such right was overwhelmingly rejected. The proposed amendment read:

> [T]he Government hereby reserves the right at all times, under rules and regulations to be prescribed by the President, to determine, fix, and control the selling price of all products derived from lands leased hereunder, whether in the crude or natural condition, or in other merchantable form, which shall be a reasonable price both as to the producer and the consumer and the reservation of such right shall be expressly stated in each lease.

58 Cong. Rec., 66th Cong., 2d Sess. at 4735 (Sept. 3, 1919).

The legislative history of the MLA thus manifests Congress' intent that the federal government be treated like any other lessor. It merely authorizes the government to enter into contracts in its proprietary capacity as owner of mineral rights. As such, MMS lacks the statutory power "to fix the obligation[s] of [federal lessees] by unilateral action." Continental, 184 F.2d at 809 (refusing to imply a right on the part of the DOI to fix the value of crude oil produced from federal lands). In short, the federal government cannot set prices under the MLA.

Moreover, the mere fact that MMS has the authority to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system" 66/ cannot be construed as a grant of authority to fix crude oil prices. Compare Chapman v. El Paso Natural Gas Co., 204 F.2d 46 (D.C. Cir. 1953) (Although the Mineral Leasing Act authorizes the Secretary of the Interior to provide "regulations and conditions as to survey, location, application, and use" of the physical aspects of rights-of-ways, the Secretary does not have authority to regulate the operation of the pipelines constructed on those right-of-ways.).

D. The Proposed Regulation Is Arbitrary, Capricious, and Contrary to Law.

Mobil does not disagree with the general proposition that MMS, by delegation of authority from the Secretary, has discretion to prescribe regulations governing royalty valuation procedures consistent with the federal statutes and leases and to modify existing regulations prospectively to accommodate changing market circumstances. MMS cannot, however, alter its well-established royalty valuation procedures absent substantial evidence that changing market conditions have made those changes necessary, nor can it introduce proposals that are arbitrary and capricious or beyond the scope of its statutory authority.

1. The Regulation is Arbitrary and Capricious and Not Supported by Substantial Evidence.

Under the Administrative Procedures Act, 5 U.S.C. § 301 et seq., agency rulemaking is unlawful and will be set aside if its findings and conclusions are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Id. § 706(2)(A). This standard requires that an agency's explanation of the basis for its decision include a "rational connection between the facts found and the choice made." Bowen v. American Hosp. Ass'n, 476 U.S. 610, 626 (1986)

66/ 30 U.S.C. § 1711.

(citations omitted). Simply put, an agency rule will be deemed arbitrary and capricious

> if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

Henley v. FDA, 77 F.3d 616, 620 (2d Cir. 1996) (quoting Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)). A reviewing court will not "conceive a basis" for the administrative action. Id. In addition to the arbitrary and capricious standard, when agency action is taken pursuant to a rulemaking provision of the APA, the action must be "[ ]supported by substantial evidence." 5 U.S.C. § 706(2)(E); Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 414, (1971).

Rulemaking based on speculation rather than demonstrable economic effect and which excludes thousands of arm's-length transactions purely on the basis of an unsupported allegation of noncompetitive pricing lacks rational footing and is therefore arbitrary and unreasonable. See supra Part IV. The proposed rule was crafted on the basis of one-sided evidence, and uncritically embraces one side of the debate. Id. **67/** Moreover, it is clear from the FOIA materials received by Mobil that MMS has not reviewed any relevant empirical data or economic studies to support its position. **68/**

67/ When an agency relies on biased evidence, courts find the resulting regulation to be arbitrary and capricious. See Gas Appliance Mfrs. Ass'n, 998 F.2d at 1046 (computer model does not consider all factors); Natural Resources Defense Council, 768 F.2d at 1420-21 (assumption in model overstated indebtedness); St. James Hosp., 760 F.2d at 1467 (study undergirding Medicare regulation had biased data base; hence, regulation invalidated); Humana of Aurora, 753 F.2d at 1583 (biased report formed basis of Medicare regulations).

68/ This serious defect was pointed out to MMS by Ben Dillon of the Independent Petroleum Association of America during the April 15, 1997 hearings in Denver, As a consequence, MMS cannot articulate a rational basis for its underlying theory that oil exchange agreements and buy/sell agreements have artificially depressed the market value of crude oil requiring the abandonment of the current regulations. See 62 Fed. Reg. 3742. In this respect, MMS has failed to articulate an explanation for the central underpinning of the rulemaking. "[A] 'rule without a stated reason is necessarily arbitrary and capricious.' " National Recycling Coalition, Inc. v. Browner, 984 F.2d 1243, 1252 (D.C. Cir 1993) (citation omitted); see also St. James Hospital, 760 F.2d at 1468 ("Compounding the statistical limitations of the study itself, moreover, the Secretary promulgated the Rule without investigating several other important aspects of the malpractice problem . . . .").

This omission is even more troublesome here than it would be in a normal rulemaking proceeding. This is the first time that MMS is claiming that it possesses the authority to negate what it concedes are arm's-length transactions and to impose a new system of formula pricing. Such agency rulemaking must be examined more strictly when there has been "a significant departure from long-standing policy." Humana of Aurora, 753 F.2d at 1582. Moreover, the agency must clearly articulate the basis of the change. Id. Here, there is clearly a departure from long-standing policy and no rational explanation provided by the Department, leading to the conclusion that the rulemaking is arbitrary and capricious.

2. The Regulation Suffers From Constitutional Infirmities.

Federal lessees have a constitutionally protected property interest in their respective leases. See generally Continental Oil Co., 184 F.2d at 810 (noting that the rights of government lessees are "valuable property rights."). MMS' attempt to capture downstream profits through administrative rulemaking constitutes a "taking" in violation of the Fifth Amendment. If MMS wishes to

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Colorado. Denver Tr. at 58. ("All we have is flip charts and slide presentations and interoffice memos. No research memos, no consultants' memos, no real analysis, just conclusions.")

obtain downstream profits, it has two options: (1) attempt to negotiate leases with producers that would require them to market downstream and to pay royalty on downstream prices; or (2) take its royalties in-kind and market the crude oil itself. MMS cannot simply "take" the downstream profits without affording lessees due process and just compensation.

CONCLUSION.

Mobil appreciates the opportunity to present its views on the proposed rule. Mobil believes that there are sound reasons for MMS to rethink its proposal. The agency's best course, in our view, is to withdraw the NOPR while it considers alternatives.